State Investment Commission
Minutes
September 26, 2003

The State Investment Commission ("the Commission") was called to order by Jonathon Miller, State Treasurer at 3:00 p.m. on September 26, 2003 in Room 264 of the Capitol Annex. Other members present were Gordon C. Duke, Secretary, Finance and Administration Cabinet and Mike Alexander, proxy for Governor Paul E. Patton.

Treasurer Miller confirmed that a quorum was present and the press had been notified of the meeting. The first item on the agenda was approval of the June 30, 2003 minutes. A motion was made by Mike Alexander and seconded by Gordon Duke to approve the minutes of June 30, 2003 meeting. **MOTION CARRIED**.

Mr. Dwight L. Price, portfolio manager, Office of Financial Management, presented the economic update. Mr. Price indicated that Kentucky Leading Index has been positive for two months in a row, and is being driven by the national economy's apparent recovery. Mr. Price indicated that collections increased with the start of the third quarter, but suggested that it will be the first quarter of FY2004-05 before it can determined if the Kentucky economy is recovering. Mr. Price indicated that the unemployment rate is at its 10-year high, 6.0 percent and has returned to the downward trend over the last 13 months. Mr. Price indicated that July was the worst month in approximately 20 years for the portfolio because of the rise in interest rates. Mr. Price further indicated that the Long-Term Pool is no longer in existence, which leaves the Short-Term Pool, Bond Proceeds Pool and the Intermediate Pool.

Steve Jones, portfolio administrator, Office of Financial Management discussed total return swaps. Mr. Jones indicated that the Commonwealth synthetically purchased $25,000,000 of Fannie Mae fives using an interest rate swap. He indicated that the swap lost approximately $800,000 in July but earned back approximately $400,000 in August-September. Mr. Jones indicated that the swap should earn $345,000 by October 15, assuming that the market experiences no price moves before then which would result in a net loss of $70,000. Mr. Jones further stated that maintaining the original assets would have resulted in a net loss of $143,000. Mr. Price indicated that the volatility in the market causes prices to change. He further indicated that research has shown that the mortgage industry has increased the volatility in the prices of the Treasuries. Mr. Price said the research shows that hedging of mortgages causes 30 percent of all price changes by mortgage companies.

Mr. Jones indicated that the money has been transferred from the Intermediate-Term Pool to the Short-Term Pool. To accomplish this, assets were sold from the Intermediate-Term Pool and transferred to the Short-Term Pool to reinvest in shorter instruments. Mr. Jones indicated that he and Mr. Price did not feel that the market environment was conducive to selling securities which prompted staff to sell a series of Agencies and synthetically repurchase them using interest rate swaps. Mr. Jones indicated that the

Commonwealth entered into a forward starting two-year swap agreement with Goldman Sachs for $30 million and a $70 million three-year swap to offset what was sold. Mr. Jones further indicated that Agency securities and swaps trade very closely together and staff feels this transaction is appropriate to maintain the Commonwealth's position. Mr. Jones stated that although the market moved against us, the swap performed exactly as predicted.

George R. Burgess, Jr., Executive Director of the Office of Financial Management, informed the members that staff is limited by the types of investments that can be purchased on behalf of the Commonwealth. He also indicated that there are no specific guidelines to follow regarding the sale of assets when credit ratings drop and the Office of Financial Management would like to adopt a policy in that regard. Mr. Burgess stated that information would be circulated to the members seeking their feedback on what would be an acceptable policy.

Mr. Price indicated that staff is considering a policy for the Commission's approval that will provide the safest and most orderly way to sell securities when credit ratings drop.

With no further business before the Commission, a motion was made by Gordon Duke and seconded by Mike Alexander to adjourn the meeting.

Sincerely,

George R. Burgess, Jr.
Secretary
State Investment Commission